Written testimony of:

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Before the
Senate Commerce Committee

October 2, 2002

Regarding
Financial Condition Of The Airline Industry

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Mr. Chairman and Members of the Committee:

- Thank you for this opportunity to testify before you today on behalf of the Air Transportation Association airlines, just over one year after the brutal terrorist assault of September 11 which rocked our nation.

- As is so well known, because terrorists used commercial aircraft as weapons of the new war, aviation security suddenly became an essential component in the larger national effort to combat terrorism.

- In recognition of that sea change, Congress quickly passed the Aviation and Transportation Security Act, creating a new federal aviation security system as part of the larger restructuring of national security.

- Much has been done as a result to make the whole aviation system more secure — to the benefit of many.

- But one year later, a review of the financial impact of government-policy-based, post-9/11 changes in aviation security shows that U.S. airlines are bearing an estimated $4 billion of the security burden that was totally unanticipated – all stemming from our nation's war on terrorism.

- Four billion dollars is a staggering amount for any industry to absorb – and, indeed, no other private sector has been asked to finance national security costs.

- The burden falls with particular weight on U.S. airlines in light of our current, unprecedented financial crisis.

- Mr. Chairman, it is the belief of the airline industry that the government had every intention of paying for the new security requirements when it passed the Security Act last year—and, certainly, the purpose was not to worsen airlines' plight by these actions.

- Today, in keeping with that original intent, we are asking for relief for the airlines from the costs of fighting the war on terrorism and providing national security for our citizens – responsibilities that are fundamentally governmental functions, appropriately paid for by the U.S. Government.

- However, Mr. Chairman, while the industry's crisis makes swift and decisive action essential, we want to be clear that we are not asking Congress for special treatment, or for what has sometimes been termed a "bail out."

- Specifically, we are not here today to request aid related to any portion of our industry's losses which are the result of economic and competitive challenges – that would constitute a bail out.

- Those marketplace factors are the responsibility of airlines themselves, to be solved using the tools of the free market – and we accept that responsibility.

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- Now, to provide context for why speedy action on this matter is required for the stability of the air transportation system, I'd like to begin with a brief industry overview.

- Referencing **Exhibit 1** in the charts attached to my statement today, you can see that in 2001, industry losses for the nine major airlines totaled $7.4 billion.

- As the footnote indicates, these losses would have reached nearly $10 billion without the aid provided by this Congress as part of the Air Transportation Safety and System Stabilization Act of 2001.

- You can see also that airline stock analysts' estimates for 2002 currently reach as high as $7 billion.

- This is one of the most discouraging numbers in this presentation, since the expectation had been that losses would be substantially reduced for 2002 as the industry fought its way to recovery.

- The next page, **Exhibit 2,** illustrates that, as of June 2002, airline debt has grown by $18 billion, a 21% jump since January 1, 2001.

- The industry, in effect, has funded growing losses with huge increases in debt, weakening substantially airline balance sheets that were already weak prior to September 11.

- The average carrier now has a debt to capitalization ratio in excess of 90% -- far higher than the average ratio for all publicly held corporations.

- Except for Southwest, the bonds of all other carriers are now rated as "junk bonds" by Standard and Poor's.

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- In the face of such challenges, airlines have acted quickly to cut losses by adjusting operations to meet the new demand environment.

- Since September 11, the major U.S. carriers[1] alone have trimmed costs by $14 billion in a series of difficult steps with far-reaching consequences:

· These self-help measures are illustrated on the chart marked **Exhibit 3:**

[1] **Source: SEC filings of American, Continental, Delta, Northwest, United and US Airways**

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- ¨ The six major hub-and-spoke carriers have **cut operating expenses by $8.7 billion or 13%**, and many airlines are also working through the painful process of renegotiating labor contracts to further lower costs.
- ♦ We've **removed 86.8 billion available seat miles**, or ASMs, from the system, a 15% reduction, <u>and</u> **267 aircraft from the fleet.**
  - These cuts have resulted in unfortunate service reductions for many cities and towns and, for the international carriers, even the elimination of service to some countries.
- ♦ And we've also **cut capital expenditures** by $5 billion, or 49%, affecting the economic health of the industries that supply goods and services to airlines and putting important technology-based customer service improvements on hold.
- ¨ Commensurate with this reduced capacity and fleet, **in a step that has been most difficult for all of us, 70,700 airline employees have lost their jobs** – representing fully 16% of the people working for the hub-and-spoke carriers.

- Even as the industry has struggled with its unique challenges, another source of financial stress has occurred as a result of the fall in the value of financial investments – namely the increasing need to deal with underfunded pension plans.
- This is shown on **Exhibit 4.**
- At the end of year 2000, assets in airline pension plans amounted to $34.8 billion, which was slightly below the projected benefit obligation.

- This year 2000 gap indicated normal fluctuations that occur in pension assets and liabilities.
- But by 2001, reflecting heavily the drop in the stock market and changes in interest rates used for asset and liability estimates, the gap had grown to $12 billion.
- Now, and in the upcoming year at least, substantial expense and cash contributions to pension plans will be required by many airlines during a time when the industry can least afford such contributions.
- We can all hope that the financial markets improve soon, since that recovery would clearly help in relieving this problem.
- But in the near term, it will cost the industry a lot to deal with the pension funding issues.

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- Now, though costs have been cut, the most obvious reason for the industry's continued losses is that revenue remains depressed – running, as a sorrowful point of context, at levels last seen in 1996.
- This reflects the development of a deeply troubling trend, which is indicated on the chart marked **Exhibit 5**.
- For 20 or more years prior to 9/11, airline fares correlated closely with the GDP – fluctuating near .95% of GDP.
- But following September 11, this connection appears to have become unhinged, with revenue amounting to only .7% of GDP.
- This is a huge change and, at the moment, there is no indication that the correlation will improve in the near-term.

- While economic factors may play some role, this clear and dramatic de-linking also suggests strongly that the airlines' revenue shortfall is closely associated with the events of 9/11 and its aftermath.

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- Mr. Chairman, let me note at this point, that our industry has fully supported the Aviation Security Act and the important improvements that have followed, even as we may have issues with some specific techniques.

- Yet as time passed following 9/11, we began to observe that the upward trends in passenger traffic were not yielding any bottom line improvement – cost reductions notwithstanding.

- This led us, starting in the second quarter, to begin scrutinizing a new source of spiraling financial pain – security costs.

- When we at Delta analyzed the cost or lost revenue for our airline related to the government-related items shown in **Exhibit 6,** we found the magnitude of the post-9/11 financial impact to be extraordinarily surprising.

- Let me review those with you now:

  - ♦ **New security tax of $2.50 per segment – $265 million**

    - This security tax was imposed on airline tickets to help offset the federal cost of security and was intended to be passed on to passengers.

    - But airlines have no current pricing power, simply because our supply of seats so far exceeds passenger demand.

    - In this high-capacity, low-demand environment, airline customers do not have to accept price increases – and they don't.

- They shop on the Internet for the lowest possible price, for example, so airlines by necessity end up absorbing the new tax.
- This converts what was intended to be a price add-on to an expense, so the tax has become a direct hit to our bottom line.

¨ **Increased terrorism insurance costs -- $150 million**

- Terrorism insurance was essentially a throw-in item for our airline insurance program prior to September 11, costing Delta only $2 million in 2001.
- Following September 11, premiums rose by an incredible $150 million for 2002.

¨ **Revenue losses due to new restrictions imposed on air carriage of U.S. mail as well as on freight shippers** - **$90 million**

- This loss is due to the elimination of airlines' right to carry mail over 16 ounces in the cargo holds of our planes, as well as restrictions on the number of shippers we can serve.
- The cargo carriers have been a major beneficiary of these rulings.

¨ **Unreimbursed costs for cockpit door fortification - $20 million**

- The government has paid a portion of the initial cockpit door modifications, but $20 million remains unfunded – and additional fortification costs are still ahead.

¨ **Loss in potential seat revenue as part of the Federal Air Marshal program** - **$35 million**

- Federal air marshals occupy space in the cabin closest to the cockpit, generally high-premium first class seats which the airlines can no longer sell.

¨ **Other mandated but unreimbursed security costs - $60 million**

- This category includes the costs to meet new requirements for increased ramp security, document verification, and screening of catering supplies.

¨ **DOT-imposed fee for passenger screening costs - $40 million**

- The DOT has chosen to exercise discretionary authority to impose monthly fees for additional screening cost reimbursement.

- Adding the financial impact of all these categories together – the new security tax, increased insurance costs, new restrictions on U.S. mail and freight, mandated cockpit door fortification, other unreimbursed security costs, and the monthly fee to the DOT – the 2002 estimated impact on Delta is $660 million.

- In addition to these items, pending legislation to arm pilots and provide self-defense training to flight crews could create large new unfunded mandates.

- Also, the current TSA plan to implement new screening requirements for checked baggage by the end of 2002 has enormous potential to impact the industry with new costs, including increased staffing demands and reduced efficiencies.

- Now, the numbers just presented are Delta numbers – airlines have not yet made a full survey to judge the industry wide impact.

- However, given that Delta represents just over one-sixth of the industry, we can roughly extrapolate to the rest of the industry by multiplying Delta's numbers by slightly more than six.

- The resulting rough estimate for the total post 9/11 security-related impact on the U.S. airline industry would be about <u>$4 billion</u>.

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- Now, based on current estimates, this $4 billion government-imposed impact could account for up to 35% of the industry's pretax operating losses for 2002.

- But, Mr. Chairman, the numbers presented so far do not account for another security consequence which has received much criticism and done major damage to airline revenues – the so-called security "hassle factor."

- Delta has conducted market research to determine the revenue loss resulting from the hassle factor – and we believe it accounts for roughly 20% of our revenue drop from 2001 to 2002.

- That amounts to almost $410 million of the annual revenue loss for Delta – or, extrapolated to the other airlines, about <u>$2.5 billion</u> for the industry as a whole, as you can see in **Exhibit 7.**

- Adding the hassle factor to the items I listed earlier, the extrapolated security-related impact on the airline industry could be on the order of <u>$6.5 billion</u> – providing a key explanation for the extreme degree of financial trouble the industry is experiencing.

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- Now, as I noted earlier, it is the airline's responsibility to deal with the marketplace factors of the current industry crisis.

- The major reductions in fleet capacity, capital expenditures, expenses, and – most regrettably -- personnel, give evidence of the hard steps already taken.

- However, as I have described, the industry's ability to address the current crisis has been seriously limited by the high and unanticipated costs of well-intended post-9/11 actions by the government.
- We recognize that the Committee has already provided flexibility for airports unable to meet the Explosive Detection System screening requirement at the end of the year, and we applaud this step.
- We are also pleased that the Committee's bill, S. 2949, would provide government terrorism/war risk reinsurance through next year.
- Therefore, in addition to supporting enactment of these provisions, we are also here today to ask you to consider a five step legislative agenda:

    1. **Eliminate the $2.50 security ticket segment tax.**
    2. **Immediately authorize airlines to carry U.S. priority mail.**
    3. **Obtain reimbursements to the airlines for unfunded security mandates.**
    4. **Eliminate the monthly security fees airlines are currently paying to the Department of Transportation.**
    5. **For any armed-pilots program or cabin crew self-defense training, ensure that associated costs are not levied on the airlines.**

- We ask you for your support in the rapid implementation of these initiatives for two important reasons.
- First, as I noted earlier, we believe the government generally has expressed through legislative intent -- that increased aviation security should be viewed as an

appropriate national security response to the September 11 national attacks which used airlines as the instruments of destruction.

- ♦ As a result, these costs should be funded through the national security funding mechanisms, not as taxes or costs imposed specifically on airlines.

- Secondly, as the final point for today, we ask for that help because aviation is key to our nation's economic health.

- The statistics are well known:

  - ♦ Airlines are a vital infrastructure for U.S. commerce, carrying 620 million passengers and 22 billion ton miles of cargo each year.

  - ♦ Air travel makes a significant contribution to the $700 billion travel and tourism industry, which employs approximately 1 of every 7 people in the U.S. civilian labor force[2]

  - ♦ Airlines' directly provide approximately 1 million jobs

  - ♦ We pay $17.7 billion in taxes -- $10 billion of those at the federal and state level.

  - ♦ And airlines provide an essential social and business link between America's cities and its smaller communities.

- Removing the national security burden from the airlines as outlined in these five steps is crucial not only to my industry, but to the millions of people, businesses, and organizations that depend on a secure, healthy, and efficient air transportation system.

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[2] **Source: Travel Industry Association of America**

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- Mr. Chairman, I want to end on one important conceptual point.

- We are not asking the government, through this hearing, for special treatment -

- We are asking for an end to special treatment -- for relief from the government-imposed consequences of the war on terrorism now uniquely borne by the airline industry.

- Thank you.